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Congress of the United States
CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of Kenneth Troske

Congressional Oversight Panel Hearing on Commercial Real Estate

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Thank you Senator Kaufman.

I would like to start by thanking the witnesses for appearing before the panel today. I recognize that all of you are very busy people with a number of other responsibilities, so I appreciate you taking time to come here and help us with our oversight responsibilities.

One common theme in the aftermath of the recent financial crisis has been that the crisis could have been prevented by more regulation. Of course in our economic system there are two sources of "regulation," that imposed by the market and that imposed by government. Both forms of regulation have their strengths and weaknesses. In my opinion, many of the calls for increased government regulation fail to recognize some of the inherent weaknesses in this type of regulation.

To begin with, it is important to recognize that regulators are human beings, not superheroes, and they respond to incentives just like all other normal human beings. And while we can argue about whether executives, shareholders, and creditors of failed companies suffered sufficiently large losses, there is no question that they lost more money in the crisis than government regulators as a direct result of firm failure. Government regulators with no "skin in the game" have little incentive to closely monitor the behavior of companies to ensure that they protect investors and the economy. In contrast, in a well-functioning market shareholders and creditors have a great deal of incentive to monitor firm behavior since they do have skin in the game. There are of course some government regulators who do an exemplary job, but there are others whose efforts will focus on merely implementing rules in a way to maintain their positions, and it is hard to know which is which before problems arise. And while it may have occurred, I know of no government regulator who lost his or her job because the firm they regulated failed or received a bailout. In fact, as a glance at the Dodd-Frank financial reform legislation reveals, many of the regulatory agencies that received the most blame for the financial crisis received additional regulatory authority in this legislation. In the end, it seems clear that regulators have little financial incentives to develop and apply the kinds of regulatory procedures that will yield maximum benefit, so we are forced to rely on regulators personal motivation for doing the right thing—hardly a sound basis for effective regulation.

We must also recognize that government regulators operate in a political process, so politics affects the outcome. When regulators try to regulate large companies, the shareholders and executives of these companies complain to their elected representatives about the undue burden of regulation, and in turn, these legislators try to limit the efficacy of regulators. We have seen this process play out time and time again in the enforcement of environmental regulation, occupational health and safety standards, and financial regulation. When companies are making large profits—as often occurs in a price bubble—it is unreasonable to expect government regulators to have the political will to defy members of Congress and pop the bubble. Note, I am not saying that the way the political process works is inappropriate. Rather I simply note that this dynamic must be kept in mind when thinking about the likely effectiveness of new regulation.

Finally, we need to recognize how executives, shareholders and creditors of financial firms will respond to regulation. All businesses, including financial firms, aim to provide the products their customers demand. It is clear that customers demanded many of the financial products that are at the heart of the financial crisis, such as collateralized debt obligations and other complicated derivatives, and customers continue to demand these products. Given this demand, one primary effect of new government regulation will be that firms will develop even more complicated and difficult to regulate financial products and work to move these products into an even more shadowy part of the banking sector where they will be even more difficult to monitor.

In addition, with an increase in governmental regulation, shareholders and creditors, who in a market economy are the strongest and most effective regulators of firms, will decrease their efforts and allow their oversight to be supplanted by the government's regulation. Given that regulation pushes companies to hide risky investments and reduces the incentives for shareholders and creditors to monitor the behavior of executives, even ideal government regulation will likely lead to a world where there are fewer crises, but those crisis that do occur will be much harder to spot, and much larger and more destabilizing. We need to ask ourselves whether this is a trade-off we want to make.

Of course the government's guarantee that systemically important financial firms will not be allowed to fail has effectively removed any incentive creditors have to monitor the behavior of executives and shareholders. Much of the new regulations appear to be attempts to fix the problems created by the existence of too big to fail firms. It seems to me that a much simpler and more efficient solution would be to simply eliminate the government's guarantee which would again provide creditors with the incentive to monitor the behavior of the firms.

Claims that the lack of regulation led to the recent financial crisis are akin to claims that someone got sick because they didn't take enough medication. As we all know, some medicine can kill you, some may prevent you from getting sick, but the correct medication is a complex function of the patient's overall health prior to becoming ill, his behavior, and the disease that he ultimately encounters. Given the complexity and uncertainty surrounding this problem, it is virtually impossible to design a regime of medication that will prevent someone from ever getting sick. Instead doctors advise us to follow a few basic rules—eat a balanced diet, exercise on a regular basis, don't smoke, avoid drinking to excess—that are designed to help build resistance to most common diseases and minimize the effects if we do become ill. However, even following these rules people still get sick. Good regulation would follow a similar course: establish a set of basic rules to enhance the ability of the natural regulators—shareholders and creditors—to oversee the behavior of managers. However, even the best government regulation will not prevent the occurrence of future financial crises; the best it can do is reduce their frequency, minimize the effects when crises occur, and make people aware of the risk so they can prepare. Responsibility for a firm's failure does not reside with government regulators, but instead rests with the managers and owners who made poor decisions. We need to keep this in mind when trying designing optimal regulation and planning for future crises. Hopefully, the testimony we hear today will help us better understand remaining problems in the market so that political leaders can continue to work toward better, more effective regulation.